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Hosaka, Rotherham & Company
Certified Public Accountants

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Senior Partner

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CEO & Managing Partner

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Retired

MENTAL HEALTH SYSTEMS, INC.

INDEPENDENT AUDITORS' REPORT

FOR THE FISCAL YEAR ENDED JUNE 30, 2012

(SUMMARIZED FINANCIAL INFORMATION FOR THE FISCAL YEAR ENDED JUNE 30, 2011)

MENTAL HEALTH SYSTEMS, INC.

INTRODUCTORY SECTION

JUNE 30, 2012

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MENTAL HEALTH SYSTEMS, INC.

FINANCIAL SECTION

JUNE 30, 2012



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INDEPENDENT AUDITORS' REPORT

Board of Directors
Mental Health Systems, Inc.
San Diego, California

We have audited the accompanying statement of financial position of Mental Health Systems, Inc. as of June 30, 2012, and the related statements of activities, functional expenses, and cash flows for the year then ended. These financial statements are the responsibility of Mental Health Systems, Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized information was derived from the Mental Health Systems, Inc.'s June 30, 2011, financial statements and was audited by others dated February 15, 2012, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Mental Health Systems, Inc. as of June 30, 2012, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 14, 2013, on our consideration of Mental Health Systems, Inc.'s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and important for assessing the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the financial statements as a whole.

Hosaka, Rotherham & Company

San Diego, California
January 14, 2013

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF FINANCIAL POSITION
JUNE 30, 2012
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2011)

	<u>2012</u>	<u>2011</u>
ASSETS:		
Current assets:		
Cash and cash equivalents (Note 3)	\$ 5,771,850	\$ 5,530,856
Investments (Note 4)	287,251	237,431
Contract receivable, net of allowance of \$350,000 (Note 5)	12,191,597	10,043,671
Other receivable	39,723	132,232
Prepaid expenditures	164,395	563,880
Total current assets	<u>18,454,816</u>	<u>16,508,070</u>
Fixed assets, net of depreciation (Note 6)	<u>12,540,980</u>	<u>12,453,527</u>
Noncurrent assets:		
Investment	5,000	3,820
Deposits	361,838	348,323
Total noncurrent assets	<u>366,838</u>	<u>352,143</u>
Total assets	<u><u>\$ 31,362,634</u></u>	<u><u>\$ 29,313,740</u></u>
 LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	\$ 3,105,158	\$ 3,154,366
Accrued payroll and related taxes	1,081,416	1,018,817
Accrued employee benefits	5,015,051	4,589,034
Deferred revenue	630,663	403,586
Other current liabilities	1,226,570	735,065
Current portion of long-term debt (Note 7)	290,278	355,167
Total current liabilities	<u>11,349,136</u>	<u>10,256,035</u>
Long-term debt:		
Notes payable, net of current portion (Note 7)	<u>9,198,427</u>	<u>8,827,829</u>
Total long-term debt	<u>9,198,427</u>	<u>8,827,829</u>
Total liabilities	<u>20,547,563</u>	<u>19,083,864</u>
Net assets:		
Unrestricted	10,787,749	10,203,609
Temporarily restricted (Note 9)	27,322	26,267
Total net assets	<u>10,815,071</u>	<u>10,229,876</u>
Total liabilities and net assets	<u><u>\$ 31,362,634</u></u>	<u><u>\$ 29,313,740</u></u>

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2012
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2011)

	Unrestricted	Temporarily Restricted	Total	
			2012	2011
REVENUES AND SUPPORT				
Contract revenues	\$ 80,420,270	\$ -	\$ 80,420,270	\$ 80,885,066
Other revenue	1,914,380	-	1,914,380	1,990,074
Fundraising, net of direct expenses	180,229	-	180,229	86,781
Donation	90,686	1,210	91,896	71,638
Total support	82,605,565	1,210	82,606,775	83,033,559
Net assets released from restrictions	155	(155)	-	-
Total revenues and support	82,605,720	1,055	82,606,775	83,033,559
EXPENSES:				
Direct expenses:				
Payroll	26,067,981	-	26,067,981	25,717,197
Payroll benefits	6,343,609	-	6,343,609	6,148,092
Purchased services	18,315,781	-	18,315,781	22,408,421
Occupancy costs	5,089,459	-	5,089,459	4,816,704
Consultants	3,504,977	-	3,504,977	3,186,255
Other direct expense	13,630,703	-	13,630,703	11,849,291
Unallocable expense	111	-	111	-
Total direct expenses	72,952,621	-	72,952,621	74,125,960
Indirect expenses:				
Payroll	4,115,790	-	4,115,790	4,027,564
Payroll benefits	669,731	-	669,731	566,283
Purchased services	-	-	-	-
Occupancy costs	424,776	-	424,776	463,136
Consultants	409,277	-	409,277	345,263
Other indirect expense	2,813,904	-	2,813,904	2,514,879
Unallocable expense	635,481	-	635,481	492,507
Total indirect expenses	9,068,959	-	9,068,959	8,409,632
Total expenses	82,021,580	-	82,021,580	82,535,592
CHANGE IN NET ASSETS	584,140	1,055	585,195	497,967
NET ASSETS, BEGINNING OF YEAR	10,203,609	26,267	10,229,876	9,731,909
NET ASSETS, END OF YEAR	<u>\$ 10,787,749</u>	<u>\$ 27,322</u>	<u>\$ 10,815,071</u>	<u>\$ 10,229,876</u>

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF FUNCTIONAL EXPENSES
FOR THE FISCAL YEAR ENDED JUNE 30, 2012
(WITH SUMMARIZED FINANCIAL STATEMENT INFORMATION AS OF JUNE 30, 2011)

	Program Service	Management & General	Total	
			2012	2011
Total Direct and Indirect Expense				
Accounting and legal	\$ 17,036	\$ 41,493	\$ 58,529	\$ 53,618
Consultants	3,504,977	409,277	3,914,254	3,531,518
Depreciation	340,611	425,726	766,337	786,328
Dues and subscriptions	18,127	80,329	98,456	86,839
Equipment rental	340,195	204,621	544,816	513,056
Housekeeping and general supplies	165,529	10,164	175,693	195,473
Insurance	2,476,543	254,689	2,731,232	2,600,373
Interest and bank fees	306,149	270,551	576,700	654,104
Laboratory fees	1,193,059	-	1,193,059	1,117,209
Licenses, fees and taxes	171,550	19,597	191,147	173,938
Minor/Major equipment	978,740	107,186	1,085,926	510,292
Occupancy costs	5,089,459	424,776	5,514,235	5,279,840
Office supplies	478,821	53,012	531,833	464,654
Other business services	2,450,626	655,332	3,105,958	1,892,357
Payroll	26,067,981	4,115,790	30,183,771	29,744,761
Payroll benefits	6,343,609	669,731	7,013,340	6,714,375
Printing and advertising	141,413	42,323	183,736	236,981
Purchased services	18,315,781	-	18,315,781	22,408,421
Repairs and maintenance	334,037	38,712	372,749	384,366
RT/ OT supplies and food	1,204,615	1,927	1,206,542	1,288,634
Staff development	390,140	125,053	515,193	451,269
Travel and transportation	1,140,327	285,042	1,425,369	1,361,566
Utilities and telephone	1,483,185	198,147	1,681,332	1,696,241
Total Direct and Indirect Expenses	72,952,510	8,433,478	81,385,988	82,146,213
Unallocable Expenses				
Bad debt	-	-	-	-
Unallowable/Unallocable Expenses	111	635,481	635,592	389,379
Total Unallocable Expenses	111	635,481	635,592	389,379
Total Direct, Indirect Expenses and Unallocable Expenses	\$ 72,952,621	\$ 9,068,959	\$ 82,021,580	\$ 82,535,592

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF CASH FLOWS
FOR THE FISCAL YEAR ENDED JUNE 30, 2012
(WITH SUMMARIZED FINANCIAL STATEMENT INFORMATION AS OF JUNE 30, 2011)

	<u>2012</u>	<u>2011</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Change in net assets	\$ 585,195	\$ 497,967
Adjustments to reconcile change in net assets to net cash from operations:		
Depreciation	766,337	786,328
Unrealized gain on investments	(16,565)	-
(Increase) decrease in operating assets:		
Contract receivable and other receivable	(2,055,416)	3,313,324
Prepaid expenditures	399,485	(90,349)
Deposits	(13,515)	16,371
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	930,913	(786,006)
Deferred revenue	227,077	79,893
Net cash flows from operating activities	<u>823,511</u>	<u>3,817,528</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment purchases	(34,435)	(51,727)
Disposals of property and equipment	128,260	31,160
Acquisition of property and equipment	(982,051)	(628,089)
Net cash flows (used in) investing activities	<u>(888,226)</u>	<u>(648,656)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds new note payable	655,000	-
Payments on notes payable	(349,291)	(328,768)
Net cash flows from (used in) financing activities	<u>305,709</u>	<u>(328,768)</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	240,994	2,840,104
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<u>5,530,856</u>	<u>2,690,752</u>
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>\$ 5,771,850</u>	<u>\$ 5,530,856</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid for interest	<u>\$ 542,843</u>	<u>\$ 624,489</u>

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 1 - ORGANIZATION

Mental Health Systems, Inc. (Organization) was organized June 2, 1978, pursuant to the General Nonprofit Corporation Law of the State of California and does not contemplate pecuniary gain or profit to the members thereof and it is organized for nonprofit purposes. The Organization was founded to provide mental health, drug and alcohol rehabilitation services in an innovative and cost effective manner primarily via government contracts. The mission of the Organization is to improve lives and instill hope by using new and creative treatment strategies while respecting time proven methods of intervention.

The Organization also provides case management services as one of California's Substance Abuse System Coordinating Agencies for the department of Corrections & Rehabilitation. In addition the Organization administers various mental health, substance abuse, vocational rehabilitation and educational programs for individuals, families and communities.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Financial Statement Presentation

The financial statements are presented in conformity with Accounting Standards Codification (ASC) 958-205, *Non-For-Profit Entities – Presentation of Financial Statements*. Under ASC 958-205, the Organization reports information regarding its financial position and activities according to three classes of net assets: unrestricted, temporarily restricted, and permanently restricted. Grants-in-aid and contributions of cash or other assets are recorded as temporarily restricted support if they are received with donor stipulations regarding their use. When a donor-imposed restriction expires, that is, when a stipulated time restriction ends or stipulated purpose restriction is accomplished temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions. As permitted by ASC 958-205, the Organization reports all temporarily restricted support as unrestricted support if the funds were expended during the same fiscal year. The Organization does not have any permanently restricted net assets.

B. Accounting Method - Basis of Accounting

The financial statements were prepared in accordance with accounting principles generally accepted in the United States of America as applicable to not-for-profit organizations. Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported on the financial statements. Basis of accounting relates to the timing of measurement made, regardless of the measurement focus applied. The Organization uses the accrual basis of accounting. Revenues are recognized when they are earned and expenditures are recognized in the accounting period in which the liability is incurred.

C. Comparative Financial Information

The financial statements include certain summarized comparative information from the prior year. This information is presented in total but not by net asset class and does not include sufficient detail to be in conformity with generally accepted accounting principles. Accordingly, such information should be read together with the Organization's financial statements for the year ended June 30, 2011, from which the summarized information was extracted. Certain amounts in the prior year financial statements have been reclassified for comparison purposes to conform to the current year presentation.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

D. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

E. Fair Value of Financial Instruments

Accounting Standards Codification ("ASC") 820 provides a definition of fair value, establishes a hierarchy for measuring fair value under generally accepted accounting principles, and requires certain disclosures about fair values used in financial statements. ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under ASC 820 aim to maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable, and the last unobservable, that may be used to measure fair value as follows:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.
- Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

At June 30, 2012, the fair value of the Organization's financial assets and liabilities that are measured on a recurring basis are categorized as follows using the fair value hierarchy:

	Total	Identical Assets (Level 1)	Observable Input (Level 2)	Unobservable Input (Level 3)
Assets:				
Cash and cash equivalents	\$ 5,771,850	\$ 5,771,850	\$ -	\$ -
Mutual funds	287,251	287,251	-	-
Securities	5,000	-	5,000	-
Total	<u>\$ 6,064,101</u>	<u>\$ 6,059,101</u>	<u>\$ 5,000</u>	<u>\$ -</u>

F. Functional Allocation of Expenses

The costs of providing the program services have been summarized on a functional basis in the statement of activities. Accordingly, certain costs have been allocated among the program services based on employees' time incurred and management's estimates of the usage of resources.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

G. Income Taxes

The Organization is exempt from income taxes under Internal Revenue Code Section (IRC §) 501(c)(3). It is, however, subject to income taxes from activities unrelated to its tax-exempt purpose. The Organization uses the same accounting methods for tax and financial reporting.

Generally accepted accounting principles (GAAP) provides accounting and disclosure guidance about positions taken by an entity in its tax returns that might be uncertain. Management has considered its tax positions and believes that all of the positions taken in its federal and state exempt organization tax returns are more likely than not to be sustained upon examination. The Organization's returns are subject to examination by federal and state taxing authorities, generally for three years and four years, respectively, after they are filed.

H. Cash and Cash Equivalents

Cash and cash equivalents are from time to time variously composed of cash on hand and in bank, and liquid investments with original maturities of three months or less.

I. Investments

The Organization presents its investments in accordance with Accounting Standards Codification (ASC) 958-320, *Not-For-Profit Entities - Investments Debt & Equity Securities*. Under ASC 958-320, investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the Statement of Financial Position. The fair values of these investments are subject to change based on the fluctuations of market values. Unrealized gains and losses are included in the change in net assets.

J. Contract receivable and accounts receivable

Contracts receivable consists of balances due for services provided pursuant to written and verbal contracts with various public and private agencies. Generally accepted accounting principles in the United States of America require that an allowance for doubtful accounts be established for accounts receivable. It is the Organization's policy to evaluate the collectability of receivables on a regular and ongoing basis, if deemed necessary, an adjustment to the allowance for bad debt account is recorded. Accordingly, contracts and accounts receivable are shown net of an allowance for doubtful accounts.

K. Fixed Assets

Fixed assets are recorded at cost and depreciated under the straight-line method over their estimated useful life. Repair and maintenance costs, which do not extend the useful lives of the asset, are charged to expense. The cost of assets sold or retired and related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal, and any resulting gain or loss is included in the earnings. Management has elected to capitalize and depreciate all assets costing \$5,000 or more; all other assets are charged to expense in the year incurred.

L. Deferred Revenue

Deferred revenue represents local funds received, but not expended. These funds must be expended in accordance with the provisions of the contract to which they apply, or if not expended in the current period, are carried over into the subsequent year.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 3 - CASH AND CASH EQUIVALENTS

Cash and cash equivalents at June 30, 2012, consisted of the following:

Deposits:	
Cash in banks	\$ 3,794,499
Money market funds	1,746,801
Certificate of deposits	200,239
Cash on hand	
Petty cash	30,311
Total cash and cash equivalents	<u>\$ 5,771,850</u>

Cash balances held in banks are insured up to \$250,000 by the Federal Depository Insurance Corporation (FDIC). The Organization maintains its cash in bank deposit accounts that at times may exceed federally insured limits. At June 30, 2012, the Organization did not have any uninsured funds.

NOTE 4 - INVESTMENTS

Investments at June 30, 2012, are summarized as follows:

Description	Cost	Fair Value	Carrying Value
Wellesley income fund	\$ 237,431	\$ 287,251	\$ 287,251
Behavioral Healthcare Solutions, Inc.	3,820	5,000	5,000
Total investments	<u>\$ 241,251</u>	<u>\$ 292,251</u>	<u>\$ 292,251</u>

The following schedule summarizes the investment return and its classification in the statement of activities as of June 30, 2012.

Interest and dividends	\$ 9,435
Unrealized gain	16,565
Check purchase	25,000
Net investment return	<u>\$ 51,000</u>

NOTE 5 - CONTRACT RECEIVABLE

Contracts receivable are balances due Mental Health Systems, Inc. for services provided and expenses incurred prior to June 30, 2011 and 2012, pursuant to written contracts with various public agencies. The balance shown on the financial statements is net of an allowance for doubtful accounts of \$350,000 and \$350,000 as of June 30, 2012, and 2011, respectively.

The Organization's policy for determining when receivables are past due is based on the contractual terms associated therewith. Management evaluates all accounts believed to be uncollectible and recognizes bad debt if all reasonable efforts to collect the amount due have been unsuccessful.

NOTE 6 - FIXED ASSETS

Fixed assets at June 30, 2012, consisted of the following:

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 6 - FIXED ASSETS (CONTINUED)

Land	\$ 3,109,368
Construction in progress	10,885
Building and facilities	10,878,751
Leasehold Improvements	950,008
Vehicles	857,235
Furniture and Fixtures	1,248,599
Software	518,259
Less: accumulated depreciation	<u>(5,032,125)</u>
Total fixed assets, net of depreciation	<u><u>\$ 12,540,980</u></u>

During the year ended June 30, 2012, \$766,337 was charged to depreciation expense.

NOTE 7 - NOTES PAYABLE

A. Long-term liabilities activity

Long-term liabilities activity includes debt and other long-term liabilities. Changes in obligations for the fiscal year ended June 30, 2012, are as follows:

	Balance 2011	Additions	Payments	Balance 2012	Due in One year
California Department of Housing and Community Development	\$ 258,439	\$ -	\$ (14,625)	\$ 243,814	\$ -
City of Oceanside #1	106,864	-	(26,864)	80,000	26,864
City of Oceanside #2	-	655,000	-	655,000	10,107
California Health Facilities Financing Authority	388,065	-	(29,191)	358,874	29,191
National Cooperative Bank	1,289,141	-	(146,120)	1,143,021	146,120
U.S. Bancorp	6,930,000	-	-	6,930,000	-
Vehicles loans	210,487	-	(132,491)	77,996	77,996
Total	<u>\$ 9,182,996</u>	<u>\$ 655,000</u>	<u>\$ (349,291)</u>	<u>\$ 9,488,705</u>	<u>\$ 290,278</u>

B. California Department of Housing and Community Development

Note payable to the Department of Housing and Community Development, a public agency of the State of California for special user housing rehabilitation known as the Boston Villas Housing Project. The thirty year note which is secured by the Deed of Trust accrues simple interest at 3% per annum, does not require interim principal payments and has a scheduled maturity date of June 29, 2019. The principal balance as of June 30, 2012 is \$162,500. Accrued interest as of June 30, 2012, is \$81,314.

C. City of Oceanside #1

The Organization has a note payable to the city of Oceanside in the amount of \$234,026. The note is a zero interest note and will be forgiven at the end of 10 years if the Organization meets all requirements. The balance as of June 30, 2012 was \$80,000.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 7 - NOTES PAYABLE (CONTINUED)

D. City of Oceanside #2

The Organization has a note payable to the City of Oceanside, a public agency of the State of California. The thirty year note which is secured by the Deed of Trust accrues simple interest at 4.75% per annum, does not require interim principal payments and has a scheduled maturity date of January 4, 2042. The principal balance as of June 30, 2012 was \$655,000.

E. California Health Facilities Financing Authority

The Organization has a note payable to California Health Facilities Financing Authority for the purchase and renovation of property located at 474 Vermont Ave., Escondido, CA. The interest is variable and will become fixed at the prevailing rate in effect at the onset of the second phase. The monthly principal and interest payment is \$3,370. The principal balance as of June 30, 2012 was \$358,874.

F. National Cooperative Bank

The Organization has a note payable to National Cooperative Bank for the purchase of the facility located at 1100 Sportfisher Drive, Oceanside, CA. The face amount of the note is \$2,250,000 with variable interest at the bank's index rate plus .25%, a 15-year loan term maturing on November 30, 2017, with minimum monthly payments of principal and interest. The note is fully collateralized by the deed of trust to the property and contains certain financial covenants and ratio requirements, of which the Organization was in compliance at June 30, 2012. The interest rate and minimum monthly payment at June 30, 2012 was 7.80% and \$21,383, respectively. The principal balance at June 30, 2012 was \$1,143,021.

G. U.S. Bancorp

The Organization has notes payable to U.S. Bancorp in the amount of \$4,952,500 (Note A) and \$1,977,500 (Note B) for the purchase and construction of property in Fresno. Interest for both loans is 5.923%. Maturity on Note A is December 17, 2015; the note is interest only; principal and any unpaid interest will be due at maturity. Maturity on Note B is December 17, 2038; interest only payments through December 17, 2015. After December 17, 2015, interest and principal is to be paid over 276 months.

H. Vehicles loans

The Organization purchased various autos throughout the year ended June 30, 2010, that were financed through Toyota and Hyundai at 5.0% and 0.0% interest, respectively. The balances in the Toyota and Hyundai notes as of June 30, 2012 were \$26,045 and \$51,951, respectively.

NOTE 8 - LINE OF CREDIT

The Organization has available an \$8,000,000 Line of Credit (LOC) with National Cooperative Bank. The LOC will mature on July 31, 2013, and has an interest rate of 4.6%. The balance as of June 30, 2012 was \$0.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 9 - TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets have been restricted by donors for specific programs within the Organization. Temporarily restricted net assets were \$27,322 and \$26,267 as of June 30, 2012 and 2011, respectively.

NOTE 10 - RETIREMENT PLAN

Mental Health Systems, Inc. has adopted a non-contributory retirement plan covering all full time employees who have met certain service requirements. The plan has received Internal Revenue Service approval under Section 401 (A) and Section 501 (A) of the Internal Revenue Code. It provides discretionary contributions by the Corporation up to the maximum amount permitted under the Internal Revenue Code, such amount to be determined annually by the Board of Directors. The contribution was \$2,093,166 and \$1,839,184 for the years ended June 30, 2012 and 2011, respectively.

NOTE 11 - OPERATING LEASES

The Organization has entered into long-term operating lease agreements for program facilities and the corporate office facility. These leases expire throughout the years ending October 2020. All facility leases include an early termination clause that allows the Organization to terminate the lease, without penalty, should the funding agency terminate funding for the program or require relocation.

The Organization leases various types of office equipment under non-cancelable operating lease agreements that expire throughout the years ending January 2016.

Aggregate future minimum operating lease commitments are as follows:

Year ending June 30,	Facilities	Equipment	Total
2013	\$ 3,311,643	\$ 138,148	\$ 3,449,791
2014	2,811,442	103,532	2,914,974
2015	2,132,414	41,300	2,173,714
2016	1,535,162	9,280	1,544,442
2017	1,236,885	-	1,236,885
2018 - 2021	2,049,556	-	2,049,556
Total future lease payments	<u>\$ 13,077,102</u>	<u>\$ 292,260</u>	<u>\$ 13,369,362</u>

During the year ended June 30, 2012, the Organization incurred expenses of \$4,322,840 and \$544,816, respectively, associated with facility and equipment leases.

NOTE 12 - MATERIAL CONTRACTS

Mental Health Systems, Inc. is the recipient of funds under numerous contracts, several of which could be considered material to the overall operations of the Organization when considered separate from other contracts. This is not considered to be a material exposure as the expenses related to such revenue can be terminated simultaneously with the cessation of revenue.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2012

NOTE 13 - BOSTON VILLAS

Boston Villas (the "Project") is a rental housing development occupied by mentally disabled persons of low income. Mental Health Systems, Inc. administers the program and also provides supportive services for the residents.

Replacement Reserve

The Organization is required to maintain a reserve for capital improvements such as replacing structural elements, furniture, fixtures or equipment of the Project. There is \$36,819 on reserve as of June 30, 2012.

Operating Reserve

The Organization is also required to maintain an operating reserve for the Project. This reserve can be used only for cash shortages that may occur resulting from unusually high maintenance expenses, seasonal fluctuations in utility costs, abnormally high vacancies, and other expenses that vary seasonally from month-to-month. There is \$16,797 on reserve as of June 30, 2012.

NOTE 14 - JOB OPTIONS, A RELATED PARTY

Three members of the Board of Directors are interested persons of entities with which the Organization engages in business transactions. One member of the Board of Directors provides leased facilities for one of the Organization's programs at fair market value. Two members are interested parties at Job Options, Inc., with which MHS has both an equipment leasing agreement and provides employee assistance counselors. The vocational rehabilitation segment of Mental Health Systems, Inc.'s business was incorporated into a separate entity known as Job Options, Inc. on April 1, 1994.

NOTE 15 - RELATED PARTIES - BEHAVIORAL HEALTHCARE SOLUTIONS, INC.

Behavioral Healthcare Solutions, Inc. ("BHS") is a for-profit company and is 100% owned by Mental Health Systems, Inc. BHS was incorporated during the year ended June 30, 2010. BHS was incorporated to administer certain government contracts. There was no activity during the fiscal year ended June 30, 2012.

NOTE 16 - SUBSEQUENT EVENT

The Organization's management has evaluated events or transactions that may occur for potential recognition or disclosure in the financial statements from the balance sheet date through January 14, 2013, which is the date the financial statements were available to be issued. Management has determined that there were no subsequent events or transactions that would have a material impact on the current year financial statements.

MENTAL HEALTH SYSTEMS, INC.
SUPPLEMENTARY INFORMATION SECTION
JUNE 30, 2012

MENTAL HEALTH SYSTEMS, INC.
SUPPLEMENTARY SCHEDULE OF OTHER DIRECT EXPENSE
FOR THE YEARS ENDED JUNE 30, 2012
(WITH FINANCIAL INFORMATION AS OF JUNE 30, 2011)

	<u>2012</u>	<u>2011</u>
Accounting and legal services	\$ 17,036	\$ 28,140
Depreciation	340,611	301,583
Dues and subscriptions	18,127	25,385
Equipment rental	340,195	371,797
Housekeeping and general supplies	165,529	188,639
Insurance	2,476,543	2,365,856
Interest and bank fees	306,149	298,263
Laboratory fees	1,193,059	1,117,209
Licenses, fees and taxes	171,550	161,448
Minor/major equipment	978,740	443,946
Office supplies	478,821	398,727
Other business services	2,450,626	1,433,401
Printing and advertising	141,413	164,385
Repairs and maintenance	334,037	340,551
RT / OT supplies and food	1,204,615	1,288,634
Staff development	390,140	329,402
Travel and transportation	1,140,327	1,095,971
Utilities and telephone	<u>1,483,185</u>	<u>1,495,954</u>
 Total other direct expense	 <u>\$ 13,630,703</u>	 <u>\$ 11,849,291</u>

MENTAL HEALTH SYSTEMS, INC.
SUPPLEMENTARY SCHEDULE OF OTHER INDIRECT EXPENSE
FOR THE YEARS ENDED JUNE 30, 2012
(WITH FINANCIAL INFORMATION AS OF JUNE 30, 2011)

	2012	2011
Accounting and legal services	\$ 41,493	\$ 25,478
Depreciation	423,929	484,745
Dues and subscriptions	80,329	61,454
Equipment rental	204,621	141,259
Housekeeping and general supplies	10,164	6,834
Insurance	254,689	234,517
Interest and bank fees	270,551	355,841
Licenses, fees and taxes	19,597	12,490
Minor/major equipment	107,186	66,346
Office supplies	53,012	65,927
Other business services	657,128	355,828
Printing and advertising	42,323	72,596
Repairs and maintenance	38,712	43,815
RT / OT supplies and food	1,927	
Staff development	125,053	121,867
Travel and transportation	285,042	265,595
Utilities and telephone	198,148	200,287
	<u>\$ 2,813,904</u>	<u>\$ 2,514,879</u>
Total other direct expense	<u>\$ 2,813,904</u>	<u>\$ 2,514,879</u>

MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEARS ENDED JUNE 30, 2012

Federal Grantor/ Pass-Through Grantor/ Program Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures
U.S. Department of Education:			
Pass-Through State of California Dept. of Rehabilitation:			
Rehabilitation Services_Vocational Rehabilitation Grants to States	84.126	N/A	\$ 700,781
Total U.S. Department of Education			<u>700,781</u>
U.S. Department of Housing and Urban Development:			
Supportive Housing Program	14.235	N/A	1,147
Pass-Through San Diego County:			
Shelter Plus Care Program	14.238	N/A	206,895
Moving to Work Demonstration Program	14.881	N/A	<u>74,383</u>
Total U.S. Department of Housing and Urban Development			<u>282,425</u>
U.S. Department of Justice:			
Pass-Through San Diego County:			
Edward Byrne Memorial Justice Assistance Grant Program	16.738	N/A	27,105
Recovery Act - Edward Byrne Memorial Justice Assistance Grant/ Grants to States and Territories	16.803	N/A	1,233,700
Pass-Through Fresno County:			
Drug Court Discretionary Grant Program	16.585	N/A	109,269
United States Federal Probation Office	N/A	N/A	<u>300,748</u>
Total U.S. Department of Justice			<u>1,670,822</u>
U.S. Department of Labor:			
Homeless Veterans Reintegration Project	17.805	N/A	300,000
Pass-Through San Bernardino County:			
WIA Youth Activities	17.259	N/A	<u>210,266</u>
Total U.S. Department of Labor			<u>510,266</u>
U.S. Department of Health and Human Services:			
Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	519,031
Pass-Through San Diego County:			
Projects for Assistance in Transition from Homelessness	93.150	N/A	68,053
Substance Abuse and Mental Health Services_Projects of			

MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (CONTINUED)
FOR THE YEARS ENDED JUNE 30, 2012

Federal Grantor/ Pass-Through Grantor/ Program Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures
Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	276,672
Teenage Pregnancy Prevention Program	93.297	N/A	193,505
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.959	N/A	3,104,306
Pass-Through Riverside County: Promoting Safe and Stable Families	93.556	N/A	483,410
Pass-Through Fresno County: Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	448,422
Medical Assistance Program, Medicaid: Title XIX	93.778	N/A	197,846
Pass-Through San Bernardino County: Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	299,994
Medical Assistance Program, Medicaid: Title XIX	93.778	N/A	1,184,440
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.959	N/A	974,337
Total U.S. Department of Health and Human Services			<u>7,750,016</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS			<u><u>\$ 10,914,310</u></u>

NOTE 1 - BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of Mental Health System, Inc. and is presented on the modified accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMC Circular A-133, *Audits of State and Local Governments and Non-Profit Organization*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in preparation of, the basic financial statement.

MENTAL HEALTH SYSTEMS, INC.
OTHER INDEPENDENT AUDITORS' REPORTS SECTION
JUNE 30, 2012



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Hosaka, Rotherham & Company
Certified Public Accountants

Roy T. Hosaka, CPA
Senior Partner

James A. Rotherham, CPA
CEO & Managing Partner

James C. Nagel, CPA
Retired

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Board of Directors
Mental Health Systems, Inc.
San Diego, California

We have audited the financial statements of the Mental Health Systems, Inc., as of and for the fiscal year ended June 30, 2012, and have issued our report thereon dated January 14, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of Mental Health Systems, Inc. is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered Mental Health Systems, Inc.'s internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Mental Health Systems, Inc.'s internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of Mental Health Systems, Inc.'s internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined previously.

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Page 2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Mental Health Systems, Inc.'s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statements amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management, the Audit/Finance Committee, others within the entity, the Board of Directors, and federal awarding agencies and pass-through entities, where applicable, and is not intended to be and should not be used by anyone other than these specified parties.

Hosaka, Rotherham & Company

San Diego, California
January 14, 2013



hrccpa.com

Hosaka, Rotherham & Company
Certified Public Accountants

Roy T. Hosaka, CPA
Senior Partner

James A. Rotherham, CPA
CEO & Managing Partner

James C. Nagel, CPA
Retired

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS
THAT COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON
INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

Board of Directors
Mental Health Systems, Inc.
San Diego, California

Compliance

We have audited Mental Health Systems, Inc.'s compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of Mental Health Systems, Inc.'s major federal programs for the fiscal year ended June 30, 2012. Mental Health Systems, Inc.'s major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Mental Health Systems, Inc.'s management. Our responsibility is to express an opinion on Mental Health Systems, Inc.'s compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Organization's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on Mental Health Systems, Inc.'s compliance with those requirements.

In our opinion, Mental Health Systems, Inc. complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the fiscal year ended June 30, 2012.

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS
THAT COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM
AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133
Page 2**

Internal Control Over Compliance

Management of Mental Health Systems, Inc. is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Organization's internal control over compliance with requirements that could have a direct and material effect on a major federal program to determine the auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Mental Health Systems, Inc.'s internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. *A material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of the internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of Management, the Board of Directors, the Audit/Finance Committee, federal awarding agencies and pass-through entities, where applicable, and is not intended to be and should not be used by anyone other than these specified parties.

Hosaka, Rotherham & Company

San Diego, California
January 14, 2013

MENTAL HEALTH SYSTEMS, INC.
FINDINGS AND RECOMMENDATIONS SECTION
JUNE 30, 2012

MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2012

A. Summary of Auditors' Results

1. Financial Statements

Type of auditors' report issued: Unqualified

Internal control over financial reporting:

One or more material weaknesses identified? Yes X No

One or more significant deficiencies identified that are not considered to be material weaknesses? Yes X None Reported

Noncompliance material to financial statements noted? Yes X No

2. Federal Awards

Internal control over major programs:

One or more material weaknesses identified? Yes X No

One or more significant deficiencies identified that are not considered to be material weaknesses? Yes X None Reported

Type of auditors' report issued on compliance for major programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with section .510(a) or Circular A-133? Yes X No

Identification of major programs:

<u>CFDA Number(s)</u>	<u>Name of Federal Program or Cluster</u>
93.556	Promoting Safe and Stable Families
16.803	Recovery act - Edward Byrne Memorial Justice Assistance Grant (JAG) Program/Grants to States and Territories
93.243	Substance Abuse and Mental Health Services_Projects of Regional and National Significance

Dollar threshold used to distinguish between type A and type B programs: \$327,429

Auditee qualified as low-risk auditee? X Yes No

MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2012

B. Financial Statement Findings

None

C. Federal Award Findings and Questioned Costs

None

MENTAL HEALTH SYSTEMS, INC.
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
JUNE 30, 2012

<u>Findings/Recommendations</u>	<u>Current Status</u>	<u>Explanation If Not Implemented</u>
None	N/A	N/A